LEGAL FRAMEWORK BEHIND INVESTOR PROTECTION EXCEPT SEBI ACT

Both the Primary and the secondary markets for corporate and Government securities are governed by the Government by means of a few legislations. These legislations have a direct bearing to protect the interest of investors. The salient features of these legislations are summed up so as to examine whether the measures are adequate to protect the interest of the investors. Hence, an attempt has been made in this chapter to bring out the legislative measures, [except SEBI Act which is summed up in the next chapter] taken by the Government to protect investors interest.

1. Income — Tax Act, 1961 and the Finance Act of Every Year

The Finance Act of every year is administered by the Income-Tax Act, 1961. The Finance Act of every year carries taxation measures of the Government including tax exemptions. To protect the interest of investors the Government gave exemption from income tax on dividend income in the hands of the tax-payers from 1997 to 2000-01, further the Government authorizes the corporates to issue tax free bonds. Indexed bonds can be issued so as to avail capital gains protection. The investors in Life Insurance Corporation Policies can claim tax rebate under section 88 of the Income Tax Act. The investment made in the securities of infrastructure providing corporations can be taken to claim additional tax
rebate. Investments made in med claim policies, super annuation fund ...etc. can be deducted from the taxable income to pay less tax.

2. The Securities Contract (Regulation) Act 1956

The object of the SC(R) Act is to prohibit undesirable transactions in the stock market so as to transform the secondary securities market as a ready market for securities and not as a place for gambling.

It gives Central Government regulatory jurisdiction over (a) stock exchanges through a process of recognition and continued supervision, (b) contracts in securities, and (c) listing of securities on stock exchanges. As a condition for recognition, a stock exchange complies with the condition prescribed by Central Government. Organised trading activities in securities take place on a specified recognised stock exchange. The stock exchange determine their own listing regulations which have to conform to the minimum listing criteria set out in the Rules

Power of the Central Government under the SC(R) Act

The Act had originally vested the following powers to the Central Government for administration of the Act:

1. To grant recognition to stock exchanges (sec 4)
2. To withdraw recognition (sec 5)
3. To call for periodic returns [sec 6(1) & (2)]
4. To direct enquiries to be made [sec 6(3) & (4)]
5. To obtain annual reports (sec 7)
6. To direct rules to be made or make rules (sec 8)
7. To make or amend bye-laws of recognised stock exchange (sec 9 & 10)
8. To supersede governing body of recognised stock exchange (sec 11)
9. To suspend business of a recognised stock exchange (sec 12)
10. To prohibit contracts in any state or area (sec 16)
11. To compel listing of securities by public companies (sec 21)
12. To make rules for the purpose of carrying out the objects of the Act (sec 30)

3. Capital Issues (Control) Act, 1947

The Act had its origin during the II world war in 1943 when the objective was to channel resources to support the war effort. It was retained with some modifications as a means of controlling and raising of capital by companies and to ensure that national resources were channeled into proper lines, i.e., for desirable purposes to serve goals and priorities of the government, and to protect the interest of investors. Under the Act, any firm wishing to issue securities had to obtain approval from the Central Government, which also

determined the amount, type and price of the issue. As a part of the liberalization process, the Act was repealed in 1992 paving way for market determined allocation of resources³.

4. Companies Act, 1956

It deals with issue, allotment and transfer of securities and various aspects relating to company management. It provides for standard of disclosure of public issues of capital, particularly in the fields of company management and projects, information about other listed companies under the same management, and management perception of risk factors. It also regulates underwriting, the issue of shares at premium and on discounts on issues, rights and bonus issues, payment of interest and dividends, supply of annual report and other informations⁴.

Investor Protection Fund

Some cushion to the interest of investor is provided by the Investor Protection Funds (IPFs) set up by the stock exchanges. Exchanges maintain an IPF to take care of investor claims, which may arise out of no-settlement of obligations by the trading members. The IPF is used to settle claims of such investors whose trading member has been declared a defaulter. In order to promote investor education and to create greater investor awareness,

4. Ibid p.23
stock exchanges have been allowed to utilize interest income earned on IPF for investor education, awareness and research.

The Companies Act, 1956 provides for an Investor Education and Protection Fund (IEPF) to protect the interest of small shareholder. The fund is utilized for conducting direct education programmes, organising seminars, and symposia, conducting specific projects for investor protection, including research activities and providing legal assistance to genuine investor litigants through investor grievances forums. The fund is managed by a committee comprising both government and non-government members.

IEF provides financial assistance to any organisation/entity/person with a viable project proposal on investors' education and protection. In order to be eligible for the assistance, the entity should be registered under the Societies Registration Act or formed as Trusts or incorporated Companies; should be in existence for a minimum period of 2 years prior to its date of application for registration for assistance; should have a minimum of 20 members and a proven record of 2 years; and should have rules, regulation and or by-laws for its governance and management.

**Disclosure of Information**

Any information that affects investors must be available to all investors in a timely fashion. One major source of information about the company is the disclosure made by the company. The Companies Act has laid down detailed guidelines for disclosure to be made by
all companies. These have been further supplemented by the Disclosure and Investor Protection Guidelines of SEBI, and the listing agreement.

The disclosure on related party transactions as required under law fall quite behind the international practices prevailing in this regard. It is only very recently that ICAI has issued accounting standards in the areas of consolidation of accounts, segment reporting, deferred taxes, related party transactions and earning per share and their applicability to continuous disclosure requirements.

Companies should promote usage of information technology for dissemination of information. Some companies however, may find it unaffordable to maintain web-sites. It would be better to have a common web-site for providing information on various companies at one place\textsuperscript{5}.

\textbf{Audit of Limited Companies, Audit of Financial Statements}

The Auditor while conducting the audit of share capital must have clear understanding of the requirements of SEBI guidelines, directions and instruction circulars issued by the board from time to time. Although not exhaustive, the provisions of SEBI (Disclosure and Investor Protection) guidelines 2000 are presented here under.

\textsuperscript{5}Ibid p.281
1. Filing of Offer Document with Board

The Company making public issue of capital shall file with the Board 21 days prior to filing of prospectus with the registered of companies, the draft offer document.

2. Companies Prohibit from Access to Market

A Company which is prohibited from accessing the capital market under any order or direction passed by the board shall not make an issue of securities.

3. Compulsory Listing

No company can make any public issue ( invitation through prospectus for subscription ) unless it has made application for listing of those securities in stock exchanges.

4. Issue of Securities in Dematerialised Form

No Company shall make public or right issue or offer for sale of securities unless it has made agreement with Depository for dematerialisation of its securities.
5. Eligibility Criteria for Public Issues by
   a) Unlisted Companies    b) Listed Companies

   An Unlisted Companies can still go in for public subscription of its proposed issue.
   No unlisted Company shall make a public issue of an enquiry share unless the company has:-

   i) Track record of distributable profits for at least three out of five immediate preceding years and
   ii) A pre-issue net worth of not less than one crore rupees in three out preceding five years with minimum net worth to be met during immediately preceding two years.

Liabilities of an Auditor

Legal Position of an Auditor

1. For not detecting misappropriation of money by the employees of the client because of incorrect accounting procedure.
2. Error in preparing the Final Accounts
3. Dishonesty or carelessness on the part of the audit (or) articled clerk of an auditor.

The liabilities of auditor from the legal point of view may be discussed under two heads, viz...,

   -a). When he is appointed by a private concern, and
b). When he is appointed by a joint stock company under the Companies Act, 1956.

a). The liability of an auditor when he is appointed by a private concern

It is not obligatory for a private concern to appoint an auditor. But if he is appointed by a private concern, his duties and liabilities are not defined by any Act. His duties, power and responsibilities depend upon their agreement which is entered into between him and his client. In other words his liability is contractual liability.

The essential elements to constitute such a liability are:-

a). He must be negligent
b). As a result of negligence, a loss is caused, and
c). The loss is suffered by the person who employed him.

b). The liability of an Auditor and The Companies Act

The case of an auditor of a limited company is different. He is appointed under the Companies Act which defines his duties and liabilities...etc.

1. Liability for negligence under the law of agency
2. Liability under the statute (misfeasance).
   a). The Companies Act, 1956, either civil or criminal
b). The Indian Penal Code

1). Liability for Negligence under Law of Agency

The auditor may be sued in a civil court for damages arising out of negligence in the performance of his duties, e.g., when the dividend has been paid out of capital. If an account of negligence in the performance of his duties. In the case of an agent who does not show as much skill and diligence in the performance of his duty and as a result of his negligence, the principal suffers a loss, the agent must compensate his principal under the law of agency.

Under Companies Act (Criminal Liability)

A criminal of an auditor arises out of an act constituting a crime, e.g., when an auditor willfully makes a false statement either in the balance sheet or any other document, destroys or mutilates and voucher or document.

"A mere mistake will not render a professional man liable for its consequence, but if the negligence was of the type where omission was to detect a fraud which by exercise of a reasonable care an accountant to think that a jury would take into account the consequential losses in their award of damages.
2. Liability under Statute (Misfeasance)

Misfeasance means breach of duty imposed by law. A duty has been imposed of an auditor of a limited company according to section 227(3) of the Companies Act to state in his report.

i). Whether he has obtained all the information and explanation required by him which were necessary for the purpose of audit,

ii). Whether in his opinion the balance sheet, prospectus, statement or any other document, required by for the purpose of.

Legal Rules under the Companies Act

1. Minimum Subscription and Application Money (sec 69)

The amount of minimum subscription has to be mentioned in the prospectus where the shares are offered to the public. The allotment of shares cannot be made unless the amount of minimum subscription has been subscribed by the public, and the public, and the application money for the amount so subscribed has been received by the company.

2. Statement in Lieu on Prospectus

The company should file with Registrar a prospectus or a statement in lieu of prospectus before making an allotment. We know that a public company having a share capital may file with the Registrar of companies a ‘statement in lieu of prospectus’ instead of issuing a prospectus to the public.

3. Time of the opening of the subscription lists(sec 72)

The shares cannot be allotted once after the issue of prospectus. The allotment can be made only from the beginning of the 5th day after the issue of prospectus. In other words, no allotment can be made until the beginning of the 5th day from the date of issue of the prospectus. It is known as the time of the opening of the subscription list.

4. Listing of Public Issue with Recognised Stock Exchanges(sec 73)

Every company, intending to offer shares or debenture to the public for subscription by the issue of a prospectus must, before such issue, make an application to at least one recognised stock exchange for permission for its shares or debentures to be dealt with the stock exchange7.

5. Depository Act, 1996

The Depository Act, 1996 provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by (a) making securities of public limited companies freely transferable subject to certain exceptions; (b) dematerialising the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form. In order to streamline the settlement process, the Act envisages the transfer of ownership of securities electronically by book entry without making the securities move from person to person. The act has made the securities of all public limited companies freely transferable, restricting the company’s right to use discretion in effecting the transfer of securities, and the transfer deed and other procedural requirements under the Companies Act have been dispensed with.

Benefits of Investors

1) Speedy Transfer of Shares etc;

With the development of National Stock Exchange and the linking up of regional stock exchanges across the country purchase and sale of securities can be conveniently conducted between persons situated far away from each other.

2) Trading Risk Avoided

Depository system take care of large number of risks involved in traditional trading involving physical transfer of shares.

3) Dematerialisation and Rematerialisation

Investor holding shares certificate can get it converted into electronic holding. Again if at some future date the investor wants to convert his electronic holding into share certificate, he is allowed such conversion is called rematerialisation.

4). Indemnification of certain Losses

Interest of owner of securities under securities under depository mode is protected as the depository takes the responsibility of indemnifying beneficial owners for any loss caused due to negligence of the depository or depository participants.

5). Low Brokerage Cost

While total brokerage cost in case of physical transfer of shares amounts to about 1.5 per cent. In case of dematerialisation it is 0.75 per cent.  

Rematerialisation Process

Investor

Submits request for rematerialisation

Depository Participant

Rematerialisation request intimated

National securities depositories Ltd.,

Registrar

Despatching scrip certificate

Confirmation of rematerialisation request

Updation records and printing scrip certificate
Dematerialisation Process

Investor

- Submits scrips certificate

Depository Participant (DP)

- Confirmation of dematerialisation
- Updates records

Registrar

- Submits scrips Certificate
- Dematerialisation request forwarded

NSDL

- Conformation of dematerialisation
- Updates records

Dematerialisation request confirmed

Conformation of dematerialisation
Right and Obligations of Depositories, Participants, Issuers and Beneficial Owners

1. Agreement between Depository and Participants

a) A depository shall enter into an agreement with one or more participants as its agent
b) Every under sub-section (1) shall be in such form as may be specified by the bye-laws.

2. Services of Depository

Any person, through a participant, may enter into an agreement, in such form as may be specified by the bye-laws, with any depository for availing its services.

3. Registration of Transfer of Services with Depository

a) Every depository shall, on receipt of intimate form a participant, registrar the transfer of security in the name of the transferee.

b) If a beneficial owner or a transferee of any security seeks to have custody of such security, the depository shall inform the issuer accordingly
4. Options to Receive Security Certificate or Hold Securities with Depository

a) Every person subscribing to securities offered by an issuer shall have the option either to receive the security certificates or hold securities with a depository.

b) Where a person opts to hold a security with a depository, the issuer shall intimate such depository the details of allotment of the security, and on receipt of such information the depository shall enter in its records the name of the allottee as the beneficial owner of that security.

5. Securities in Depositories to be in Fungible Form

a) All securities held by a depository shall be dematerialized and shall be in a fungible form

6. Rights of Depositories and Beneficial Owner

a) Not withstanding anything contained in any other law for the time being in force, a depository shall be deemed to be the registered owner for the purposes of effecting transfer of ownership of security on behalf of a beneficial owner.

b) Save as otherwise provided in sub-section(1) the depository as a registered owner shall not have any voting rights or any other rights in respect of securities held by it.

c) The beneficial owner shall be entitled to all rights and benefits and be subjected to all the liabilities in respect of his securities held by a depository.10

Investors Duties

Execution of Orders

A Stock broker, in his dealings with the clients and the general investing public, must faithfully execute the orders for buying and selling of securities at the best available market price and not refuse to deal with a small investor merely on the ground of the volume of business involved.

Issue of Contract Note

A stock broker has to issue, without delay to his client, a contract note for all transactions in the form specified.

Breach of trust

A stock broker must not encourage disclose or discuss with any other person or make improper use of the personal investments and other informations of a confidential nature of the client which he comes to know in this business relationship.

Business and Commission

A stock brokers must not encourage sales or purchase of securities with the sale object of generating brokerage (or) commission.
Business of Defaulting Clients

A stock broker should not deal or transact business knowingly, directly or indirectly, or execute an order for a client who has failed to carry out his commitments in relation to securities with another stock broker.

Fairness to Clients

A stock broker who dealing with a client, must disclose whether he is acting as a principal or as an agent. He must ensure at the same time, that no conflict of interest arises between him and the client.

Investment Advice

A stock broker must not make a recommended to any client who might be expected to rely there on to acquire, dispose of, retain any securities unless he has reasonable grounds for believing that the recommendation is suitable for such a client upon the basis of facts, if disclosed by such a client as to his own security holdings, financial situation and objectives of such investments

Competence of Stock Broker

A stock broker should have adequate trained staff and arrangements to render fair, prompt and competent services to the clients.\(^{11}\)

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\(^{11}\) Varshney P.N and Mittal D.K., Indian Financial System, Sultan Chand and Sons, New Delhi, 1998 p.1.221 – 1.222
Conclusion

Both the primary and the secondary markets for corporate and Government Securities are governed by the Government by means of a few legislations. Legal framework behind investors protection [except SEBI Act] taken by the Government to protect investors' interest is discussed. Under the Income Tax, the Government protects the interest of the investors by exempting the dividend income in the hands of the tax-payers from an income-tax from 1997 to 2000-01. The Securities Contract (Regulation) Act gives the Central Government regulatory jurisdictions over a) stock exchanges through a process of recognition and continued supervision. b) Contracts in securities c) Listing of securities on stock exchanges. Under the Control of Capital issue Act 1947, any firm wishing to issue securities had to obtain approval from the Central Government, which also determines the amount, type and price of issue. Companies Act, 1956 deals with issue, allotment and transfer of securities and various aspects relating to company management. Depository Act, 1956 provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities. Apart from these legislation, the SEBI Act has a direct bearing to protect the investors and as such the provisions of SEBI Act to protect Investors have been explained in the next chapter.